United States Court of Appeals

for the Second Circuit

PETITION FOR REHEARING

75-7256

United States Court of Appeals

FOR THE SECOND CIRCUIT

S. WILLIAM GREEN, EVELYN GREEN and CYNTHIA COLIN, as Executors of the Estate of LOUIS A. GREEN, deceased, and EVELYN GREEN, individually, and as stockholders of Kirby Lumber Corporation, suing on behalf of themselves and for the benefit of said corporation and for the class of all other stockholders of said corporation similarly situated,

Plaintiffs-Appellants,

against

SANTA FE INDUSTRIES, INC., SANTA FE NATURAL RESOURCES, INC., KIRBY LUMBER CORPORATION, and MORGAN STANLEY & CO.,

Defendants-Appellees.

Appeal from the United States District Court for the Southern District of New York

PETITION FOR REHEARING

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PETITION FOR REHEARING EN BANC

This petition for rehearing _en banc_ is submitted, pursuant to Rules 35 and 40, Federal Rules of Appellate Procedure, on behalf of defendants-appellees Santa Fe Industries, Inc., Santa Fe Natural Resources, Inc., and Kirby Lumber Corporation.

Preliminary Statement

The decision of the panel in the present case, which both the majority and the dissent characterize as "interesting" and "important", represents a sweeping transformation of Section 10(b) and Rule 10b-5. In a break with previously established law, the majority, in condemning a short-form merger established by Delaware law, has held, as Judge Moore notes in his dissent (p. 1983), "that failure to disclose is no longer a prerequisite for liability under Rule 10b-5 -- that, in fact, liability under the anti-fraud provisions of 10b-5 will attach in the _complete absence_ of any deception or misrepresentation, in short, in the complete absence of fraud altogether" [emphasis in original]. Even more alarmingly, the majority has held that an admittedly scrupulous observance of the Delaware statute constituted, in itself, a device or artifice to defraud. Ignoring the teaching of _Erie_ v. _Tompkins_, the majority has imposed a requirement of "corporate purpose" for a short-form merger, contrary

to the Delaware statute. In further disregard of the Erie doctrine, the majority has condemned, as a breach of corporate fiduciary duty, conduct which is expressly sanctioned by the state which created the corporation. All of this has been done on the basis of a contention (the need for a "corporate purpose") which had been abandoned by the appellants in this Court and thus not briefed by either party. This, in turn, apparently led the majority into a misapprehension of a critical fact necessary to its "corporate purpose" rationale.* For all the reasons assigned we submit this case should be re-examined by the full court.

Statement of Facts

The facts relevant to the issues presented herein are simple, and undisputed. Since 1936, a controlling interest in Kirby Lumber Corporation ("Kirby") was owned by Santa Fe Natural Resources, Inc. or a predecessor ("Resources"), which in turn is wholly owned by Santa Fe Industries, Inc. ("Santa Fe"), the parent company of the Santa Fe Railroad. Since 1967, Resources had owned approximately 95 per cent of the stock of Kirby. Plaintiffs were among the minority shareholders who owned the remaining 5 per cent.

Section 253 of the Delaware Corporation Law ("DCL") permits a parent corporation, which owns at least 90 per cent of the stock of a subsidiary, to merge with that subsidiary,

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* As developed below, the panel based its "corporate purpose" requirement on the premise that the majority shareholder "use[d] corporate funds to force extinction of the minority shareholders' interest". This is incorrect. The funds for the purchase of the minority shares were actually contributed by the majority shareholder (Appendix p. 18A).

and to buy out the minority shares for cash. Section 253, known as the "short-form merger" statute, does not require advance notice to the minority stockholders. However, notice of the merger must be given within ten days after its effective date, and any shareholder who is dissatisfied with the amount of cash offered for his stock is entitled to demand an appraisal in the Delaware Court of Chancery. DCL §§ 253(d), 262.

Resources determined to invoke the provisions of Section 253. It obtained, from Appraisal Associates, a written appraisal of the physical assets of Kirby. This appraisal was furnished to Morgan Stanley & Co., for the purpose of obtaining a valuation of the stock. Morgan Stanley submitted a report valuing the stock at $125 per share. Resources thereafter decided to offer the minority stockholders $150 a share.

To implement the short-form merger, Resources caused to be organized another Delaware corporation, Forest Products, Inc. ("FPI"). The funds necessary to purchase the minority shares were given to FPI by the majority shareholder, Resources, together with its 95 per cent holding of Kirby stock, and Resources assumed all of FPI's and Kirby's expenses in connection with the merger (Appendix 18A). The merger was completed and, within the time specified by Delaware law, notice thereof was sent to the minority shareholders. Accompanying the notice was an information statement (Appendix pp. 12A-71A) which included, in addition to the Morgan Stanley valuation and extensive financial data on Kirby, the appraisals of the physical assets, showing a liquidation value for the assets equivalent to $722 a share.

The record is bereft of the slightest suggestion that there was involved here the practice of "'going public' when the market is flourishing and squeezing out the public shareholders when the market is depressed" (concurring opinion p. 1968). Further, the record indicates that the $150 offered the minority was substantially higher than any price paid for the stock in recent years.

It is upon the facts set out above that the majority of the panel held that the amended complaint stated a claim of fraud. As Judge Moore noted in his dissent (p. 1982):

> "At this point it is essential to underscore what was <u>not</u> involved in the merger. There was no failure to comply with state law. There was no failure to disclose by the defendants. On the contrary, all of plaintiffs' assertions of stock value derived from the report circulated by the defendants to the minority shareholders. Similarly, there was no misrepresentation of fact or law made to the minority." [Emphasis in original.]

REASONS FOR GRANTING REHEARING

<u>There is no Foundation in the Statute or the Rule for the Majority's Elimination of Deceit and Non-Disclosure as Elements of an Action under Rule 10b-5.</u>

Less than a year after the Supreme Court has reaffirmed the historic relationship of Rule 10b-5 to "the tort of deceit and misrepresentation" (<u>Blue Chip Stamps</u> v. <u>Manor Drugstores</u>, 421 U.S. 723, 744 (1975)), the majority of the panel has eliminated deception and non-disclosure as necessary elements of the Rule. In holding that Rule 10b-5 will support an action for "breaches of fiduciary duty by a majority against minority shareholders without any charge of misrepresentation or lack of disclosure" (p. 1951), the panel has made a major break with previously existing law, including the decision of this Court in <u>Popkin</u> v. <u>Bishop</u>, 464 F.2d 714 (1972). Although the

majority states at one point (p. 1960) that Popkin "impliedly supports our decision in this case", it is clear that Popkin, and the numerous authorities in accord with it, have been impliedly overruled by the panel.

In an effort to reconcile the instant decision with Popkin, the majority has ignored crucial portions of the opinion. Thus, the majority relies on various passages from the Popkin opinion as yielding the "plain implication" that "in cases such as the short-form merger, where no shareholder approval is required, there is no need for a showing of misrepresentation or lack of disclosure to make out a 10b-5 case" (p. 1961). This statement is inexplicable, in view of the conclusion which was stated in Popkin, on the same page as one of the passages selected for quotation by the majority (464 F.2d at pp. 719-720):

> "Thus, it seems clear that our emphasis on improper self-dealing did not eliminate non-disclosure as a key issue in Rule 10b-5 cases. Section 10(b) of the Exchange Act and Rule 10b-5 are designed principally to impose a duty to disclose and inform rather than to become enmeshed in passing judgments on information elicited."

No significant difference appears between the facts of Popkin and those of the present case. Popkin was not a short-form merger, and notice to shareholders was accordingly sent before the merger, while here the notice was sent within ten days after the merger as provided by the Delaware statute; that distinction, however, is without substance. Since, as the majority acknowledges (pp. 1947, 1956, 1974), the law of Delaware is that a short-form merger cannot be enjoined, and

that appraisal is the exclusive remedy (Stauffer v. Standard Brands Inc., 187 A.2d 78, 80 (Del. Sup. Ct. 1962)), mailing of the notice before rather than after the merger would have made no difference.* The requirements of Rule 10b-5 are satisfied so long as full disclosure is made in time to permit shareholders to decide whether to accept the parent corporation's offer, or demand appraisal. As was stated by the Popkin Court, in terms directly applicable to short-form mergers (p. 720, note 16):

> "Where the right to appraisal and payment for shares is the exclusive shareholder remedy under state law, the federal disclosure provisions are still not 'nugatory.' They will help ensure that shareholders have the information necessary for an intelligent exercise of their appraisal rights."

An examination of the other cases cited by the majority shows, as set forth in Judge Moore's dissent (pp. 1983-1987), that each of them involved some element of the deceit or nondisclosure which the majority of the panel has now read out of the statute and the rule. For example, in Voege v. American Sumatra Tobacco Corp., 241 F.Supp. 369 (D. Del. 1965), one of the two cases cited by the majority as "judicial support" for its novel ruling, the defendants had concealed the fact that they contemplated a partial liquidation of assets, which would result in a higher yield per share than the total price being

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* Similarly, it is circular reasoning for the majority to suggest (p. 1956) that absence of advance notice can violate Rule 10b-5 by preventing an injunction suit under Rule 10b-5. The advance notice which would allow time to seek an injunction would, simultaneously, extinguish the cause of action on which the injunction would be based.

offered to the minority (241 F.Supp. at p. 373).* The Court in Voege expressly acknowledged that "Rule 10b-5 is inapplicable unless a seller has been deceived" (ibid., p. 375). Similarly, Rekant v. Desser, 425 F.2d 872 (5th Cir. 1970), is cited in Judge Mansfield's concurring opinion for the proposition that "the Fifth Circuit has repeatedly held corporate insiders liable under Rule 10b-5 in the absence of misrepresentation" (p. 1976). In fact, the Court in Rekant expressly based its holding on findings that the defendants had made "affirmative misrepresentations" in reports to shareholders, and had "violated the director's duty to disclose fully the material facts. . ." (425 F.2d at p. 882).

Nonetheless, the majority has swept aside the cases requiring deceit, and has, as Judge Moore stated (p. 1983), found 10b-5 liability "in the complete absence of any deception or misrepresentation, in short, in the complete absence of fraud altogether" [emphasis in original]. Such a holding, we submit, mandates examination by the full Court.

The Requirement of "Corporate Purpose" Created by the Majority of the Panel has No Foundation in Law, and was Based Upon a Misapprehension of the Facts in the Record

The majority seeks (p. 1961) to distinguish Popkin on the ground that the merger there had a "corporate purpose", while the present case is characterized as an instance where

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* The other case cited at page 1959, Bryan v. Brock & Blevins Co., Inc., 490 F.2d 563 (5th Cir. 1974), cert. denied 419 U.S. 844, was not decided under Rule 10b-5 but under Georgia state law. See, 490 F.2d at p. 571.

"controlling shareholders of a publicly held corporation use corporate funds to force extinction of the minority shareholders' interest for the sole purpose of feeding the pocketbooks of the controlling shareholders" (p. 1968) [emphasis supplied]. This distinction is invalid for several reasons. First, nothing in the Popkin decision even suggests that presence or absence of "corporate purpose" had any bearing on the result. On the contrary, as the statements quoted above made clear, the Court there based its entire analysis on the disclosure requirements of Rule 10b-5.

Moreover, in adopting sua sponte the "corporate purpose" argument, which plaintiffs had not briefed and had effectively abandoned on this appeal,* the majority of the panel misapprehended a critical fact. The record is uncontradicted that defendants did not use corporate funds of Kirby to purchase the minority shares. When Resources, the majority stockholder, transferred its Kirby stock to FPI, it also transferred to FPI $3,798,675 of its own funds (Appendix, p. 18A), in order to purchase the 25,324-1/2 minority shares, at $150 per share. Thus, even assuming that the majority's novel propositions of law were valid as to a case where "the corporation pays for the stock bought from the minority shareholders" (p. 1956),

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* At page 33 of their brief, plaintiffs stated that:

> "We need not argue that every short form merger without business purpose is in violation of Rule 10b-5; the gravamen of our complaint is that the price is unconscionable - a violation whether or not it has a business purpose."

these propositions would have no application to the present facts. The majority's misapprehension of this critical fact, repeatedly stressed (pp. 1948, 1956, 1958), requires, we submit, re-examination of its decision.*

This fact, among others, distinguishes the present case from Marshel v. AFW Fabric Corp., F.2d Dkt. No. 75 - 7404 (2d Cir. Feb. 13, 1976), cited at p. 1959 of the majority opinion, where corporate funds were used to purchase the minority shares. Also unlike Marshel, the present case does not involve a situation, of the kind on which Judge Mansfield dwells at length, where the controlling shareholder is "'going public' when the stock market is flourishing and squeezing out the public shareholders when the market is depressed" (p. 1968). On the contrary, the record herein indicates that the valuation placed on the minority shares was far higher than any price paid for the stock in previous years (Appendix, p. 26A). The record further shows that Resources never caused Kirby to "go public" at all: rather, Resources acquired its controlling interest in Kirby many years ago, by operation of law (ibid.).**

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* The majority's "corporate purpose" test would be arbitrary, in any event, since it bears no causal relationship to the injury allegedly suffered by minority shareholders. If the minority shareholders were in fact being paid an inadequate price, the harm to them would not be affected in any way by the presence or absence of a "corporate purpose".

** For the same reason the various articles from such publications as Dun's Review and Business Week, cited by Judge Mansfield (pp. 1968-70) as support for the majority's opinion, are inapposite. The articles quoted in the concurring opinion were not "current appraisals of the short-form merger device", but rather concerned long-form mergers where controlling shareholders "were buying back their interests at only a fraction of the price at which they originally were sold to the public . . ." (p. 1969).

In the absence of any dishonest or malevolent conduct, of the kind which has been present in every previous case where a violation of Rule 10b-5 was found, plaintiffs acknowledged (Principal Brief, p. 33) that "the gravemen of [their] complaint" was the alleged undervaluation -- for which Delaware law admittedly provides a remedy of appraisal. The majority, however, recognized that undervaluation in itself was not sufficient to violate Rule 10b-5 (pp. 1960, 1962-3), and accordingly affirmed the dismissal of the complaint as to Morgan Stanley & Co. (p. 1966). Nonetheless, the net result of the decision is to impose upon the courts of this Circuit the new and unnecessary burden of determining valuation and appraisal cases, which otherwise would be heard in the state courts where they belong.*

The Majority has Initiated the Creation of a Federal Common Law which Would Unjustifiably Supplant Valid State Corporate Statutes

In order to extend Rule 10b-5 to what is essentially an appraisal case, the majority of the panel was thus constrained to find "fraud" in the alleged lack of corporate purpose, and the absence of advance notice to the minority shareholders (pp. 1960, 1962-3). In undertaking to transform Section 10(b) and Rule 10b-5, from guarantees of full disclosure to charters for the substantive regulation of corporate affairs, the panel

* Thus as Judge Mansfield recognizes, absent rescission, it will be necessary to determine a "fair buy-out price" [i.e. appraisal] (p. 1968).

specifically recognized that the Delaware statute provides for elimination of minority interests under 10 per cent "without prior notice to the minority shareholders" and "without any statement of corporate purpose" (p. 1955). The majority nevertheless proceeded to hold that following the Delaware procedure constituted a "fraud" as a matter of federal law.

In reaching this result, the majority has gone far beyond holding, as it states at page 1949, that remedies created by state corporate law "are not pre-emptive or exclusive". What the majority has in fact held is that use of the short-form merger procedure, expressly sanctioned by the legislature and courts of Delaware, constituted a "fraud" in and of itself -- a truly unique position.

Further, the majority was able to reach this result only by holding that the complaint sufficiently alleged "breaches of fiduciary duty by a majority against minority shareholders" (p. 1951). This "fiduciary duty", however, has been imposed by the majority of the panel as a matter of federal common law, in a situation where the Supreme Court of Delaware has clearly held that no such fiduciary duty exists, and that the holders of a less than ten per cent minority interest have no vested right to remain stockholders.*

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* Stauffer v. Standard Brands Inc., 187 A.2d 78, 80 (Del. Sup.Ct. 1962); Coyne v. Park & Tilford Distillers Corporation, 146 A.2d 785 (Del. Ch. 1958), aff'd 154 A.2d 893 (Del. Sup.Ct. 1959); Cf. Matter of Willcox v. Stern, 18 N.Y.2d 195 (1966); Garzo v. Maid of the Mist Steamboat Co., 303 N.Y. 516 (p. 1952).

In overriding the Delaware law, the majority was clearly moved by its disapproval of the policy underlying Delaware statutes "thought to be favorable to corporate management and designed to attract corporations to the state for the purpose, among others, of raising revenue for the state and furnishing business for the members of the legal profession located in Delaware" (p. 1955).* Petitioners submit, however, that the relevant issue before the Court is not the wisdom of the policy judgments made by the Delaware legislature. The real issue is whether Rule 10b-5 authorized, in the words of Judge Moore's dissent (p. 1978), "the use of their powers by two judges of one of the eleven judicial Circuits to override and nullify not only the corporate laws of Delaware with respect to short-form corporate mergers, but also, in effect, comparable laws in an additional thirty-seven States". We submit that Judge Moore is correct, and that the subject is not a proper one for the sweeping judicial legislation which is contained in the opinion of the majority. See Evans v. Abney, 396 U.S. 435, 449 (1970). The danger of creating federal common law in this area was forcefully stated in a recent commentary, incorrectly cited by the majority

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* In fact, as noted in Judge Moore's dissent (p. 1978), at least 38 of the 50 states have similar statutes. Moreover, this type of short-form merger statute did not originate in Delaware, as the majority suggests; rather Section 253 is modeled upon an earlier statute in New York. Stauffer v. Standard Brands, Inc., 187 A.2d 78, 80 (Del. Sup.Ct. 1962).

(p. 1959) as supporting its position. Borden, Going Private -- Old Tort, New Tort or No Tort? 49 N.Y.U. L.Rev. 987. After recalling the unfortunate developments under the doctrine of Swift v. Tyson, Professor Borden noted (p. 1039):

> "If the federal securities laws are to be pushed so far beyond their original purpose as not only to enforce recognized standards of fiduciary obligations but to create new ones in a hotly debated area without deference to state law or empirical study or any balancing of the numerous competing social interests involved, one may suppose that one day there will again be a recognition of the 'mischievous result' of judicial lawmaking based upon an alleged 'transcendental body of law outside of any particular State' which federal courts in their good judgment may discern and apply. We will then have in the securities field our own Erie v. Tompkins." [Footnotes omitted.]

Further, although the Delaware statute does not require the statement of a corporate purpose for short-form mergers, such mergers may actually serve a number of valid purposes, as Judge Moore noted in his dissent (p. 1997). See also Borden, supra, 49 N.Y.U. L.Rev. at 1006-7. As the Borden article further notes (49 N.Y.U. L.Rev. at p. 1025), the short-form merger statutes existing in the majority of the states may be taken to represent "a substantive determination that take-outs are socially desirable transactions when within the percentage limitations of such statutes, with a strong implication that they are not socially desirable when the parent holds a lesser percentile interest in the subsidiary". One may take issue with the substantive policy

judgments behind such statutes -- as the majority of the panel obviously did -- but the responsibility of the courts in this connection "is to construe and enforce the Constitution and laws of the land as they are and not to legislate social policy on the basis of our own personal inclinations". Evans v. Abney, 396 U.S. 435, 447 (1970). We respectfully urge that the policy judgments of the state legislatures, as well as the previously existing law under Section 10(b) and Rule 10b-5, should not be set aside merely because a majority of a panel of federal judges, considering the same policy questions, would have arrived at a different and novel conclusion. At the least, this drastic and sweeping change in the law should receive the consideration of the entire Court.

CONCLUSION

For all the reasons assigned, it is respectfully requested that the petition for rehearing *en banc* be granted, and that upon rehearing the decision of the District Court should be affirmed.

Respectfully submitted,

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